FILE COPY

Office Supreme Court
FILED
OCT 31 1932
CHARLES ELMORE CROPLEY
CLERK

Supreme Court of the United States.

OCTOBER TERM, 1932.

No. 434.

THE UNITED STATES, PETITIONER,
v.
DAKOTA-MONTANA OIL COMPANY.

On Petition for Writ of Certiorari to the Court of Claims.

BRIEF ON BEHALF OF RESPONDENT IN OPPOSITION.

HERMAN J. GALLOWAY,
LOUIS P. DONOVAN,
Attorneys for Respondent.

TABLE OF CONTENTS.

Opinion below 1
Jurisdiction 1
Question Presented 1
Statutes and Regulations Involved 2
Deductions Allowed Corporations 3
Statement 4
Argument 6
Both the Statute and Treasury Regulations Require the Allowance of Depreciation upon Drilling Costs 7
If the Regulations do not Require or Permit a Depreciation of the Drilling Costs, these Regulations are Contrary to the Statute and are Invalid 16
Decision by U. S. Circuit Court of Appeals, Fourth Circuit, in *Petroleum Exploration* v. *Commissioner* is Erroneous 24
Conclusion 27

LIST OF CASES CITED.

Burnet *v.* Moore Cotton Mills Co., 49 Fed. (2d) 59 18
Burnet *v.* Petroleum Exploration, 23 B. T. A., decided Oct. 3, 1932, C. C. A. 4th Cir. 6, 14, 15, 24
Consolidated Mutual Oil Co. *v.* Commissioner, 2. B. T. A. 1067 ..... 12, 25
Crooks *v.* Harrelson, 282 U. S. 55 ..... 17, 18
Gould *v.* Gould, 245 U. S. 151 17
Jergins Trust Co. *v.* Commissioner, 22 B. T. A. 551, 562 ..... 12, 25
Lynch *v.* Alworth Stephens Co., 267 U. S. 364 9
Old Farmers Oil Co. *v.* Commissioner, 12 B. T. A. 203, 217 ..... 10, 12, 25
Palmer, Trustee, *v.* United States, 67 C. Cls. 648, 653, 654 18
P. M. K. Petroleum Co. *v.* Commissioner, 24 B. T. A. 360 14
Reinecke *v.* Trust Co., 278 U. S. 339 17
United States *v.* Ludey, 274 U. S. 295, 300, 302, 303 ..... 8, 9, 11, 13, 17
United States *v.* Merriam, 263 U. S. 179, 187, 188 17
United States *v.* Missouri Pac. R. Co., 278 U. S. 269 17
Ziegler *v.* Commissioner, 23 B. T. A. 1091 14

LIST OF STATUTES AND REGULATIONS CITED.

Revenue Act of 1926 (44 Stat. 9, 16, 24, 41) 2, 7
Regulations #69, articles 161, 162, 163, 164, 165, 201, 203, 207, 221, 223, 225, 561 ..... 3, 18, 19, 20, 21, 22

Supreme Court of the United States.

OCTOBER TERM, 1932.

No. 434.

THE UNITED STATES, *Petitioner*,
v.
DAKOTA-MONTANA OIL COMPANY.

On Petition for Writ of Certiorari to the Court of Claims.

BRIEF FOR THE RESPONDENT IN OPPOSITION.

OPINION BELOW.

The findings of fact and the opinion by the Court of Claims are reported in 59 Fed. (2d) 853.

JURISDICTION.

The judgment of the Court of Claims was rendered on July 5, 1932 (R. 16). Petition for writ of certiorari was filed on October 5, 1932 (R. 16). Jurisdiction is invoked under the authority of Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED.

Whether under the Revenue Act of 1926 an allowance for depreciation should be made upon the costs of drilling an oil well, the wells upon which the expenditures were so made resulting in producing wells, the production of oil from such

wells being included in the income for the taxable year and the expenditures for the drilling cost having been capitalized?

STATUTES AND REGULATIONS INVOLVED.

The pertinent portions of the Revenue Act of 1926 (Ch. 27, 44 Stat. 9, 16, 26, 41) are as follows:

"SEC. 204. (c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that — * * *

"(2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

"SEC. 214. (a) In computing net income there shall be allowed as deductions:

* * * * * * * * * * *

"(8) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *"

"(9) In the case of * * * oil and gas wells, * * * a reasonable allowance for * * * depreciation of improvements, according to the peculiar conditions in each case; * * *."

"SEC. 234 (a) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions: * * *

"(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

"(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary." * * *

The following articles of Regulations 69, promulgated under the Revenue Act of 1926, are pertinent:

"DEDUCTIONS ALLOWED CORPORATIONS:

"ART. 561. *Allowable deductions.*—In general the deductions from gross income allowed corporations are the same as allowed individuals, * * *. Particularly, * * * as to depreciation, see articles 161–170; as to depletion, see articles 201–237; * * *."

"ART. 221. *Depletion in the case of oil and gas wells.*—Under section 204 (c) (2), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ per cent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. In no case shall the deduction computed under this paragraph be less than it would be if computed upon the basis of the cost of the property or its value at the basic date, as the case may be. In general, 'the property,' as the term is used in section 204 (c) (2) and this article, refers to the separate tracts or leases of the taxpayer."

"ART. 223. *Charges to capital and to expense in the case of oil and gas wells.*—Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a development expense or charged to capital account returnable through depletion. If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation. The cost of drilling nonproductive wells may at the option of the operator be deducted from gross income as a development expense or charged to capital account returnable through depletion and depreciation as in the case of productive wells. An election once made under the provisions of this article will control the taxpayer's returns for all subsequent years."

"ART 225. *Depreciation of improvements in the case of oil and gas wells.*—Both owners and lessees operating oil and/or gas properties will, in addition to and apart from the deduction allowable for depletion as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under article 223. The amount deductible on this account shall be such an amount based upon its cost or other basis equitably distributed over its useful life as will bring such

property to its true salvage value when no longer useful for the purpose for which such property was acquired. Accordingly, where it can be shown to the satisfaction of the Commissioner that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property, the amount annually deductible for depreciation on such property may be based upon the length of life of the deposit. (See articles 161–170.)"

STATEMENT.

The findings of fact made by the Court of Claims (R. 5 to 9) may be summarized as follows:

The respondent, a North Dakota corporation, kept its books and made its income tax return for the calendar year 1926 on an accrual basis (R. 5). During the years 1923 to 1926, both inclusive, respondent expended a large sum of money for labor, fuel, hauling, freight, supplies, material and equipment used in drilling oil wells, casing the same, erecting derricks, etc., and for all items of cost in the drilling and completion of producing oil wells ready to connect the same to a pipe line (R. 5). The findings of fact show the amounts spent each year for the following separate divisions of expense: (1) Cost of equipment and materials; (2) Cost of freight, hauling, installing equipment and materials, and (3) Total cost of drilling (labor, fuel, etc.) (R. 5). All of these expenditures were capitalized by respondent and included in its invested capital. The productive life of all of these producing wells, the expenditures for which were so capitalized, was more than one year (R. 6). The findings of fact also show the estimated oil reserves on the properties upon which these expenditures were made during the pertinent years, and show the amount of oil produced from such properties during the calendar year 1926 (R. 6).

The respondent claimed a deduction for depletion of 27½ per cent of its gross income from these properties during the taxable year in accordance with the provisions of the statute, and also claimed a depreciation upon a unit of production based upon the total amount expended in the drilling and completion of such producing oil wells (R. 7). The Commissioner of

Internal Revenue then allowed the deduction for depletion as claimed, but allowed a deduction for depreciation only upon the costs of the equipment and materials and rejected the claim for a depreciation upon the cost of (1) freight, hauling, installing equipment and materials, and (2) the total cost of drilling (R. 7).

The respondent then brought this action in the Court of Claims to recover the tax imposed and collected by the Government because of the disallowance of the depreciation claimed, and the Government stipulated that the allowance for depreciation should be increased, and among other things conceded that an allowance for depreciation should be made not only upon the cost of equipment and materials which the Government had previously allowed but also that an allowance for depreciation should be made upon the cost of freight, hauling and installing of the equipment and materials (R. 10), which concessions resulted in an admitted overpayment of tax by respondent in the sum of $8,420.21 (R. 9). The Government, however, contended that the actual cost of drilling the well, including the labor, fuel, etc., that is the cost of putting the drill hole in the ground, should not be made the subject of depreciation, but was covered by the allowance for depletion (R. 10). The Court of Claims determined that not only (1) the costs of the equipment and materials and (2) the cost of the hauling, freight, etc., of the equipment and materials should be subjected to an allowance for depreciation, but that the entire cost of creating the producing oil well including (3) the drilling costs should be made the subject of an allowance for depreciation (R. 9 to 14) and rendered its judgment accordingly.

During the calendar years 1922, 1923, and 1924, the respondent had charged as operating costs certain expenditures made by it for early and preliminary costs incident to the oil leases and preliminary to the drilling, construction, and completion of the oil wells (R. 8). The Government required the respondent to set up said expenditures in its tax returns for the calendar year 1926 as capital investments, and accordingly increased respondent's capital investment for that calendar year in the amount so set up (R. 8). The respondent claimed a deduction for depreciation upon these expenditures and the

Court of Claims allowed such depreciation. The Court of Claims rendered judgment for the respondent for the principal sum of $19,096.12 (R. 16), which included the sum of $8,420.21 conceded by the Government.

ARGUMENT.

There is little attempt beyond the formal "Specification of Errors" in the Government's brief at p. 5, to show that the decision of the Court of Claims is wrong. The argument is based in the main upon the contention that the question involved is an important one in the administration of the tax laws, that there are other cases involving a large sum of money which will depend upon the decision of this question, and that the decision of the Court of Claims is in conflict with the decision by the United States Circuit Court of Appeals for the Fourth Circuit in the case of *Burnet, Commissioner,* v. *Petroleum Exploration,* decided on October 3, 1932 (not yet reported but printed as an appendix to the petition for writ of certiorari). The respondent contends that the decision by the Court of Claims is preeminently sound, and that the decision by the Circuit Court of Appeals for the Fourth Circuit is unsound. The respondent therefore respectfully submits to the court that if it establishes in this brief in opposition to certiorari that the decision by the Court of Claims is sound this court should deny the petition for writ of certiorari regardless of the importance of the question or the number of other cases that may turn upon its decision. To do otherwise would impose an unfair hardship and burden upon the respondent. The respondent has been deprived by the Government of its money under the guise of taxation. It has been diligent in the assertion of its rights. It has prevailed in a trial of its case in a court of justice and has procured the rendition of an opinion which is sound and correct. To require the respondent in these circumstances to bear the burden of further trying this case simply because of the importance of the question presented, even though the decision by the lower court may be right, results in irreparable injury, damage and hardship to the respondent, especially in view of the fact that there is no means

of having additional costs or damages assessed against the United States.

It is therefore respectfully submitted that if the respondent establishes to the satisfaction of this court that the decision by the Court of Claims is sound and correct, the petition for writ of certiorari in this case should be denied regardless of the importance of the question or the amount involved in other cases.

Both the Statute and the Treasury Regulations Require the Allowance of a Depreciation upon Drilling Costs.

Section 234 (a) (8) of the Revenue Act of 1926 provides:

"(a) In computing the net income of a corporation subject to the tax imposed by Section 230, there shall be allowed as deductions:

"(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. * * *"

This statute expressly requires that depletion shall be allowed. It also expressly requires that an allowance shall be made for depreciation of improvements. Depletion and depreciation are separate and distinct. Each has a well defined meaning. The word "depletion" is derived from the Latin word "deplere," meaning to empty or exhaust. "Depreciation" is derived from the Latin word "depretaire," meaning to lessen in price or value. The word "improvement" also has a well known meaning, and is defined as being that by which the value of anything is increased or as an amelioration of the condition of property affected by the expenditure of labor or money for the purpose of rendering it useful for other purposes than those for which it was originally used, or more useful for the same purpose.

Applying these definitions to the statute, it means that there shall be in the case of oil wells or other natural deposits a reasonable allowance for the emptying or exhaustion of the

deposits, and a reasonable allowance for the lessening in value or the increased value of the property resulting from the expenditure of labor or money. The decision by this court in the case of *United States* v. *Ludey*, 274 U. S. 295, clearly shows that such definition and meaning was that which Congress had in mind in the Revenue Acts relating to oil wells. At p. 300 the court said:

"The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents the reduction, during the year, of the capital assets through wear and tear of the plant used. The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with the salvage value) suffice to provide an amount equal to the original cost. The theory underlying this allowance for depreciation is that by using up the plant, a gradual sale is made of it. The depreciation charged is the measure of the cost of the part which has been sold. * * *"

Again, on p. 302, the court said:

"The depletion charge permitted as a deduction from the gross income in determining the taxable income of mines for any year represents the reduction in the mineral contents of the reserves from which the product is taken. The reserves are recognized as wasting assets. The depletion effected by operation is likened to the using up of raw material in making the product of a manufacturing establishment. As the cost of the raw material must be deducted from the gross income before the net income can be determined, so the estimated cost of the part of the reserve used up is allowed. The fact that the reserve is hidden from sight presents difficulties in making an estimate of the amount of the deposits. The actual quantity can rarely be measured. It must be approximated. And because the quantity originally in the reserve is not actually known, the percentage of the whole withdrawn in any year, and hence the appropriate depletion charge, is necessarily a rough estimate. But Congress concluded, in the light of experience, that it was better to act upon a rough estimate than to ignore the fact of depletion."

The court, in that same case, at p. 303, pointed out that the Corporation Tax Law of 1909 contained no provision for deductions on account of the depletion of mineral reserves, and said:

"The resulting hardship to operators of mines induced Congress to make provision in the Revenue Law of 1913 and all later Acts for some deduction on acount of depletion in determining the amount of the taxable income from mines. It is not lightly to be assumed that Congress intended the fact to be ignored in determining whether there was a loss or a gain on a sale of the mining properties. The proviso limiting the amount of the deduction for depletion to the amount of the capital invested shows that the deduction is to be regarded as a return of capital, not as a special bonus for enterprise and willingness to assume risks. It is argued that, because oil is a fugacious mineral, it can not be known that the reserve has been diminished by the operation of wells. Perhaps some land may be discovered which, like the Widow's cruse, will afford an inexhaustible supply of oil. But the common experience of man has been that oil wells, and the territory in which they are sunk, become exhausted in time. Congress in providing for the deduction for depletion of oil wells acted on that experience. Compare *Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364. In essence, the deduction for depletion does not differ from the deduction for depreciation."

It is respectfully submitted that Congress specifically provided in Section 234 of the Revenue Act of 1926, that there should be an allowance for depletion or exhaustion of the natural deposits, that is, an allowance for the diminution of that which had been placed upon the property by Nature. Congress further provided that there must be a reasonable allowance for the depreciation of improvements, that is, an allowance for the diminution in value of that which had been placed upon the property by man.

It is further submitted that a proper construction of the regulations issued by the Treasury Department is not at all in conflict with this expressed purpose and intent of Congress, but is in full accord with the same.

Article 221 of the Regulations provides that the taxpayer may deduct on account of depletion an amount equal to 27½

per cent of the gross income from the property during the taxable year. This is merely the adoption of the method specifically provided in the statute. It will be recalled that prior to the Revenue Act of 1926 depletion was calculated upon a unit of production basis, and upon a discovery value. The flat percentage was adopted by Congress to avoid the difficulties and uncertainties of the calculation of the discovery value.

Article 223 of the Regulations undertakes to give to the taxpayer the option of charging drilling costs to operating expenses or to invested capital, and provides that if charged as operating costs all may be deducted in the year in which expended. While not necessary for determination of this case, it is interesting to note that the Board of Tax Appeals has decided that such costs are capital investments, and that the Commissioner has no power by regulation to change their character and to permit their deduction as current expenses (*Old Farmers Oil Co.* v. *Commissioner*, 12 B. T. A. 203, 217). This regulation further provides that if these expenses are charged to invested capital, in so far as they are represented by physical property, they may be taken into account in determining a reasonable allowance for depreciation.

Article 225 of the Regulations provides that in addition to and apart from the deduction allowable for depletion there will be permitted a reasonable allowance for depreciation of property such as machinery, tools, equipment, pipe, etc., so far as not in conflict with the option exercised by the taxpayer under Article 223, and that the amount deductible on this account shall be such an amount based upon its cost or other basis equitably distributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired, and that where it can be shown that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal, useful life of the physical property, this amount annually deductible for depreciation may be based upon the length of life of the deposit.

In these regulations, the Treasury has expressly recognized the mandatory requirement of Congress that there shall be an

allowance not only for depletion but also for depreciation, and it is respectfully submitted that a proper construction of these regulations recognizes the true distinction between the allowance for depletion and depreciation, namely, that depletion should be allowed for the lessening in value of the oil deposits which were placed there by Nature, and depreciation shall be allowed for the lessening in value of all improvements placed there by man. Such a construction is consistent with the express words and purpose of the statute, also with the true and well understood meaning of the terms depletion and depreciation, and with the decision of this court in the case of *United States* v. *Ludey*, 274 U. S. 295.

The facts in this case show that the expenses upon which respondent has been allowed by the Court of Claims a deduction for depreciation are all the costs of erecting and constructing a completed oil well, which includes not only the costs of the material and equipment, and the costs of hauling, freight, etc., upon such materials, but also the cost of drilling the oil well.

The regulations permit a depreciation upon expenditures represented by physical properties. *Physical* has been defined as relating to what is material and perceived by the senses, specifically pertaining to the material part or the structure of an organized being as opposed to what is mental or moral. It is also defined as that which is external, obvious to the senses and cognizable through a bodily or material organization.

Physical properties mean those properties which can be seen, and which are obvious to the senses, as opposed to those which are mental or moral and have no definite existence.

The respondent submits that a completed oil well is a physical thing. It is also an improvement or an addition to the property. It can be seen. It can be touched. It performs a useful function or duty. It is obvious to the senses. It has no purely mental, moral, or intangible characteristics. An oil well consists of an aggregation of physical things such as pipes, sleeves, derricks, pumps, various articles of steel, timber, etc., and before the oil well as such and as a completed structure is brought into existence all of these component parts must be put together to produce the ultimate physical object which is the completed oil well. Without the labor of drilling the hole,

the fuel to run the drill, the freight, and the hauling of the casings, and the materials themselves, and all of such things for which these expenditures were incurred, these objects would never produce a completed oil well which, as above stated, is the ultimate physical object or property here involved, and such parts would always remain only component parts thereof, scattered at distant points over the face of the earth.

A producing oil well is a physical property. The mere fact that a portion thereof extends into the bowels of the earth does not prevent it from being a physical object or physical property. It is a structure and is the result of a construction project. The hole in the ground is as much a part of the completed oil well as any other component part such as casings, derricks, etc. Without the hole in the ground the oil well could not be completed or brought into existence.

It is respectfully submitted that even a mere hole in the ground which is constructed by man is a physical object. When constructed for the purpose of being used as an oil well or even a well for drinking water, it is a physical thing, it becomes physical property, and is an improvement upon the premises.

The Board of Tax Appeals in *Jergins Trust Co.* v. *Commissioner*, 22 B. T. A. 551, had under consideration this very question and decided in accordance with the contentions of the respondent in the case at bar. Remarks by the Board in that case are especially interesting and persuasive. Such remarks are in part as follows (p. 562):

"The final contention of petitioner is that respondent erred in adding its drilling and development expenses to the amounts recoverable through depletion. Petitioner has waived its contention that these costs are proper subjects for annual deductions and apparently concedes that they should be capitalized. We believe that this is the proper solution of the problem. Compare *Consolidated Mutual Oil Company*, 2 B. T. A. 1067, *Old Farmers Oil Company*, 12 B. T. A. 203. Both parties agree that these capital expenditures are returnable to petitioner during the life of its lease and they differ only as to the character of the deduction. Respondent has allowed it as depletion, while petitioner claims it as depreciation. Respondent has added these expenditures to amounts recoverable through depletion and has thus determined a larger depletion

unit. Ordinarily, where there is no difference as to the rate, it would become immaterial whether the capital cost was recovered as depreciation or as depletion. But section 234 (a) (8) of the Revenue Act of 1924 as restricted by section 204 (c) of the same act places certain limitations on the deduction for depletion while the deduction for depreciation is subject to no such restrictions. In the present case the restriction operates to deny to petitioner the full amount of the deduction for depletion to which it would otherwise be entitled. Under these conditions it becomes necessary to discuss the character of the deduction. Section 234 (a) (9) of the Revenue Act of 1921 and section 234 (a) (8) of the Revenue Act of 1924 permit the deduction in cases such as this of 'a reasonable allowance for depletion and for depreciation of improvements, * * *.' As we understand the stipulation, the amounts in controversy were expended in drilling wells and in operations preparatory and relating to such drilling, all of which would constitute a part of the cost of the structure recoverable through depreciation. On the other hand, the concept of the term 'depletion' is the exhaustion of the mineral content of a mine or an oil well. *United States* v. *Ludey*, 274 U. S. 295. The precise wording of the statute indicates clearly that Congress had in mind the distinction between the exhaustion of the natural resources and the recovery of the capital invested in the improvements necessary to work the property. It can not be seriously contended that the exhaustion of petitioner's investment in preparing for and in drilling its wells constitutes any part of the exhaustion of its oil reserves.

"The Commissioner relies upon Article 223 of Regulations 62 which provides:

> " 'Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a development expense or charged to the capital account returnable through depletion. *If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation.* * * *' (Italics supplied.)

"If this regulation is susceptible of the construction which has been placed upon it in this case, it is in conflict with the provisions of the statute, which allows improvements to be

depreciated. It seems to us, however, that the regulation has not been properly applied in this case. The construction used in computing the deficiency was that tangible assets which go upon the property, such as lumber, cement, casing, tubing, etc., are all charges that 'are represented by physical property while other costs were not.' The cost of labor for erecting the derrick or drilling the well, the fuel used in such operation, the cost of hauling such materials are all 'represented by physical property.' The Commissioner in his brief recognizes that such is the case and now urges that we sustain his action upon the ground that the stipulated facts are insufficient to show what part of the amounts disallowed were represented by physical property. The stipulation shows that the Commissioner has allowed as the cost of improvements (the word used in the statute) only the amounts expended for physical equipment and has refused to treat as cost of improvements amounts expended for wages, fuel, repairs and hauling 'in connection with development and drilling.' This terminology excludes the idea that any part of such amount was expended in discovery or exploration work or in operating the leased property. Amounts expended in development and drilling operations convey to us the impression of expenditures for improvement of the property upon which the statute permits the taxpayer to deduct depreciation. The adjustment of taxable income will be accomplished by allowing as depreciation the amounts previously treated as depletion allowances upon these expenditures."

This case was recently reversed by the United States Circuit Court of Appeals for the Ninth Circuit (decision as yet unreported), but the reversal was upon other grounds, and the conclusion by the Board of Tax Appeals upon the question of depreciation was not discussed or disturbed.

The Board of Tax Appeals has also followed this ruling in *Petroleum Exploration* v. *Commissioner*, 23 B. T. A. 890; *Ziegler, et al.* v. *Commissioner*, 23 B. T. A. 1091; and *P. M. K. Petroleum Company* v. *Commissioner*, 24 B. T. A. 360. The United States Circuit Court of Appeals for the Fourth Circuit has reversed the Board of Tax Appeals in the *Petroleum Exploration* case. The opinion is not reported but a copy is printed as an appendix to the petition for writ of certiorari herein. This decision will be hereinafter discussed.

The Government contends that the cost of drilling the hole

in the ground is more directly related to the value of the mineral deposit and therefore should be returned through the allowance for depletion instead of the allowance for depreciation, and that the hole in the ground does not wear out or become exhausted and therefore can not be made the subject of depreciation. This is an arbitrary attitude and an attempt to avoid the application of the general rules, and would have the effect in this case of defeating the purpose of the statute.

The usefulness of the hole in the ground does become exhausted and wears out. The hole in the ground has no further use after the oil is removed, and the statute required a reasonable allowance for "the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence." It also required a depreciation of improvements. The exhaustion of the useful life of the hole in the ground comes clearly within these requirements, and as we have heretofore shown comes clearly within the proper construction of the regulations requiring an allowance for depreciation of expenditures made for physical properties. The concessions by the Government in the Court of Claims in this case clearly demonstrate the correctness of respondent's contention and the error of the Government's position. Although the Commissioner of Internal Revenue had refused to allow a depreciation upon the cost of the freight and hauling of the casing, material, and equipment, the Government conceded in the Court of Claims that such an allowance for depreciation should be made. It is interesting to note that although the Government conceded this item in the Court of Claims it apparently made no such concession in the *Petroleum Exploration* case in the Fourth Circuit because the Court of Appeals in the last paragraph of the decision in that case emphatically determines that these costs should be made the subject of an allowance for depreciation. The cost of freight upon a casing, and the cost of hauling that casing from the railroad to the site of the oil well is just as intimately and closely connected with the oil deposit as is the cost of drilling the hole in the ground. That expenditure can have no useful life or purpose other than in connection with that particular oil well. When that oil well to which the casing has been hauled and delivered becomes entirely

depleted, the value of the expenditure for freight and hauling is entirely gone. That expenditure does not wear out, nor does it have a salvage value after the life of the oil well, but the useful life of that expenditure is entirely exhausted when the oil well becomes entirely depleted. There is no sound reason why a deduction for depreciation upon the cost of freight and hauling of materials and equipment should be allowed, and a deduction upon the cost of drilling the hole should be denied. This inconsistency by the Government proves the error of its contention and the correctness of the contention by respondent.

It is respectfully submitted that the completed oil well is an improvement as the term is used in the statute, and a physical property as the term is used in the regulations, and that an allowance for depreciation should be made for all of the expenditures in the construction of such completed oil well. It is therefore submitted that not only the statute but also a proper construction of the regulations require the allowance of such a deduction, and that the action by the Commissioner in denying a deduction upon the cost of drilling a hole is inconsistent both with the statute and with the regulation.

If the Regulations do not Require or Permit a Depreciation of the Drilling Costs, these Regulations are Contrary to the Statute and are Invalid.

While we feel confident that the regulations not only permit but require an allowance for depreciation upon drilling costs, we contend that if these regulations do not require or permit of such a deduction the regulations are in conflict with the express provisions of the statute and are therefore beyond the power of the Commissioner, and are invalid.

We have heretofore shown that the statute (Section 234 (a) (8)) specifically provides that in the case of oil and gas wells there should be made "a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case"; we have also shown that the words depreciation and depletion are separate and distinct and have well defined meanings. This principle was recognized

and announced by the decision of the Supreme Court in the case of *United States* v. *Ludey*, 274 U. S. 295. In view of the fact that some of the earlier Revenue Acts did not contain provisions for depletion and that such conditions resulted in an injustice, and that the later Revenue Acts contained specific provisions for depletion and also provided for depreciation (see *Ludey* case at p. 302), it can not be seriously contended that Congress in any manner confused the two terms.

In considering this question, we should also bear in mind the rules of statutory construction to the effect that the primary rule is to ascertain and give effect to the intent of the legislative body, and that where the language of a statute is plain and unambiguous and conveys a clear and definite meaning, resort must not be had to rules of construction, but the statute must be given its plain and obvious meaning (*United States* v. *Missouri Pacific R. Co.*, 278 U. S. 269). Courts will not legislate but will construe the statutes as framed by the Congress. The words will be considered as used in their ordinary sense and the literal meaning of a statute will not be departed from by the courts unless a literal construction produces an absurdity so gross as to shock the general moral and common sense (*Crooks* v. *Harrelson*, 282 U. S. 55).

In dealing with taxing statutes, the general rule requiring adherence to the letter of a statute applies with peculiar strictness. See *Crooks* v. *Harrelson*, *supra*, at p. 61.

In the case of *United States* v. *Merriam*, 263 U. S. 179, 187–188, the court said that in statutes levying taxes the literal meaning of the words employed is most important and such statutes are not to be extended by implication beyond the clear import of the language used.

Where, however, the language of a statute is of doubtful meaning, of course the court must construe the ambiguity, but in construing such ambiguity in a tax statute the same must be resolved in favor of the taxpayer and a taxing statute should not be extended by implication beyond the clear import of the language used (*Gould* v. *Gould*, 245 U. S. 151; *United States* v. *Merriam*, 263 U. S. 179, *Reinecke* v. *Trust Company*, 278 U. S. 339).

It is also a well settled rule that the Secretary of the Treasury

can not by his regulations alter or amend a revenue law (*Morrill* v. *Jones*, 106 U. S. 466), and while the regulations made by the Commissioner have the force and effect of statutes if made with the approval of the Secretary of the Treasury and pursuant to statutory authority, yet, if they are not reasonable or are in conflict with the statute, the regulations are invalid (*Burnet* v. *Moore Cotton Mills Company* (C. C. A. 4th), 49 Fed. (2) 59; *Palmer, Trustee*, v. *United States*, 67 C. Cls. 648 at 653, 654).

We respectfully urge that the statute says that both depreciation and depletion shall be allowed. Depreciation has the well established meaning of being the lessening in value of the improvements upon a property, while depletion has the well recognized and established meaning of a diminution of the natural deposits. Depletion of the natural deposits under this statute should not be confused with depreciation, and the depreciation of the improvements should not be confused with the depletion of the natural deposits. The statute is in the conjunctive and requires that both should be allowed. See *Crooks* v. *Harrelson*, *supra*.

We have heretofore shown that these drilling costs become a part of the improvements put upon the property by mankind and are in no manner a part of the natural reserve or the mineral deposit. They are separate and distinct therefrom and any act of the Commissioner, whether by regulation or otherwise, that attempts to prevent the return of the investment in such improvements by way of depreciation is contrary to the statute and therefore under the decisions cited is invalid and must be ignored.

An examination of other provisions of Regulations 69 dealing with the question of depreciation and depletion conclusively shows that the Commissioner had in mind the distinction between depreciation and depletion and the reasons fundamental to each, and that if the regulations are not given the construction for which we have heretofore contended, it is submitted that they become inconsistent with each other as well as with the express provisions of the statute.

In Article 161, of Regulations 69, it is stated that:

"*Depreciation.*—A reasonable allowance for the exhaustion,

wear and tear, and obsolescence of property used in the trade or business may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a reasonable consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the property in the business, equal the basis of the property determined in accordance with section 204 and articles 1591–1603. Due regard must also be given to expenditures for current upkeep."
* * *

Article 162 provides that:

"*Depreciable property.*—The necessity for a depreciation allowance arises from the fact that certain property used in the business gradually approaches a point where its usefulness is exhausted. The allowance should be confined to property of this nature. In the case of tangible property, it applies to that which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence due to the normal progress of the art, as where machinery or other property must be replaced by a new invention, or due to the inadequacy of the property to the growing needs of the business. It does not apply to inventories or to stock in trade, nor to land apart from the improvements or physical development added to it. It does not apply to bodies of minerals which through the process of removal suffer depletion, other provisions for this being made in the statute. (See sections 204 (c), 214 (a) (9), and 234 (a) (8) and articles 201–237 and 1602)."
* * *

Article 163 provides that:

"*Depreciation of intangible property.*—Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights, licenses, and franchises. Intangibles, the use of which in the business or trade is not so limited, will not usually be a proper subject of such an allowance. If, however, an intangible asset acquired through capital outlay is known from experience to be of value in the business for only

a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation allowance, provided the facts are fully shown in the return or prior thereto to the satisfaction of the Commissioner."

Article 164 provides that:

"*Capital sum recoverable through depreciation allowances.*—The capital sum to be replaced by depreciation allowances is the cost or other basis of the property in respect of which the allowance is made. (See article 1602.)" * * *

Article 165 provides that:

"*Method of computing depreciation allowance.*—The capital sum to be replaced should be charged off over the useful life of the property, either in equal annual installments or in accordance with any other recognized trade practice, such as an apportionment of the capital sum over units of production. Whatever plan or method of apportionment is adopted must be reasonable and must have due regard to operating conditions during the taxable period. While the burden of proof must rest upon the taxpayer to sustain the deduction taken by him, such deductions must not be disallowed unless shown by clear and convincing evidence to be unreasonable." * * *

Article 201 provides that:

"*Depletion of mines, oil and gas wells; depreciation of improvements.*—Sections 214 (a) (9) and 234 (a) (8) provide that taxpayers shall be allowed as a deduction in computing net income in the case of natural deposits a reasonable allowance for depletion of mineral and for depreciation of improvements. * * *

"The essence of these provisions of the statute is that the owner of mineral deposits, whether freehold or leasehold, shall, within the limitations prescribed, secure through an aggregate of annual depletion and depreciation deductions the return of either the cost of his property, or the value of his property on the basic date plus, in either case, subsequent allowable capital additions, but not including land values for purposes other than the extraction of minerals. * * *

"When used in these articles (201–237) covering depletion and depreciation—* * *

"(c) A 'mineral property' is the mineral deposit, the de-

velopment and plant necessary for its extraction, and so much of the surface only as is reasonably expected to be underlaid with the mineral. The value of a mineral property is the combined value of its component parts.

"(d) A 'mineral deposit' refers to minerals only, such as the ores only in the case of a mine, to the oil only in the case of an oil well, and to the gas only in the case of a gas well, and to the oil and gas in the case of a well producing both oil and gas. The value of a mineral deposit is the value of the mineral property, less the value of the plant and equipment, and less the value of the surface of the land for purposes other than mineral production. The cost of a mineral deposit is that proportion of the total cost of the mineral property which the value of the deposit bears to the value of the property at the time of its purchase.

"(e) 'Minerals' include ores of the metals, coal, oil, gas. * * *

"(g) 'Depletion or depreciation sustained' means (except in cases where a discovery value has been established, as to which see (h) below) depletion or depreciation actually sustained, whether legally allowable or not, based on the cost or value as at the basic date, as the case may be."

Article 203 provides that:

"*Amount returnable through depletion and depreciation deductions in the case of lessee.*—(a) In the case of a lessee, the amount remaining in any year returnable through depletion and depreciation deductions is (1) the value as of the basic date of the lessee's equity in the property plus (2) subsequent allowable capital additions and minus (3) depletion and depreciation sustained, whether legally allowable or not, from the basic date to the taxable year, and minus (4) the residual value of other property at the end of operations. The amount returnable through depletion is the total capital remaining less the sum recoverable through depreciation. The provisions of this paragraph do not apply to the computations of the depletion allowance in the case of oil and gas wells when such allowance is based on the income from the property."

Article 207 provides the method for the determination of the fair market value of oil and gas properties, and, among other things, provides that:

"* * * The development cost includes expenditures for drilling wells to maintain or increase production or to develop

additional unproven areas, and the cost of improvements necessary to the development of the property, such as roads, warehouses, water lines, etc. The operating cost includes all current expenditures for producing, preparing, and marketing the oil and/or gas produces, such as pumping oil wells, repairs of oil or gas wells, cleaning sanded wells, shooting wells, redrilling old wells, labor and supplies for collecting oil, repairs to separators, pumps, and collecting lines, repairs to buildings and structures, repairs to field tools, equipment, fixtures and machinery, superintendence, other field expenditures, overhead, etc. (due consideration being given to taxes), exclusive of allowable capital additions as defined in article 223 and deductions for depreciation and depletion. The cost of repairs is not to be confused with the depreciation deduction by which the cost or value of plant and equipment is returnable to the taxpayer free from tax." * * *

From the above it will be seen that the Commissioner of Internal Revenue has recognized the distinction between depreciation and depletion. He has also recognized the fundamental basis of the theory of depreciation and has specifically said in Article 162 that it does not apply to bodies of minerals which through the process of removal suffer depletion. He has also said that it is the intention to permit the return of the capital sum invested in property used in business and that this sum should be charged off over the useful life of the property either in equal annual installments or by an apportionment of the capital sum over the units of production.

In Article 201 he again expressly recognizes the distinction between depreciation and depletion where he says that in the case of mines, oil and gas wells, the taxpayers should be allowed as a deduction in computing net income "in the case of natural deposits a reasonable allowance for depletion of mineral and for depreciation of improvements." He then goes on and explains the theory that the depletion shall cover the mineral deposits.

It is respectfully submitted that if it should be held that under the provisions of Articles 221, 223 and 225 of Regulations 69 these costs can not be made the subject of depreciation, then these articles become inconsistent with the other articles of Regulations 69 which have just been discussed, and it is

further submitted that Articles 221, 223 and 225 so construed become inconsistent with the express words of the statute which require the allowance of both depreciation and depletion and that such depreciation and depletion are separate and distinct and have been so recognized by the Commissioner of Internal Revenue in other articles of these same regulations.

It is manifest that Congress intended that the operation of the provision with reference to depreciation and depletion should permit the return of the capital investment of the taxpayer over the period of years of operation. The Regulations above quoted clearly recognize and state this principle (article 201). It is equally manifest that an oil well as well as the investment therein will have no useful life after the oil in paying quantities has been exhausted. The arbitrary allowance for depletion is 27½ per cent of the income for a given year. This bears absolutely no relation to the amount of money expended in the drilling of wells upon the property, but as the regulations of the Treasury Department will reveal, and as the statements by the courts in the decided cases will show, was an arbitrary figure which from experience was believed just and was arrived at in order to avoid the many difficulties in the ascertainment of depletion quantities and discovery values, but it was never meant to have any application to the recovery of the capital investment in the cost of the construction of oil wells and such operating properties.

In the case at bar, it will be seen that in the year 1926 out of an estimated oil reserve of 825,253.33 barrels upon the property known as the Emmons Lease, there was extracted a total of 641,596.59 barrels of oil (R. 6). It will thus be seen that to deny the respondent the right to recover its capital investment in improvements by way of depreciation and to compel it to rely upon its chances of recovering the same by way of depletion will work a particular hardship in this case. In the first place, the deduction for depletion has no reference to or connection with the amount of the cost of the improvements. In the second place, the 27½ per cent is given upon the income for the year, whereas during the current year approximately ¾ of the oil reserve was removed. These two facts alone show that Congress must have had in mind the thing for which we

have above contended, namely, that depletion and depreciation should be allowed according to their well understood meanings and should not in any manner be confused.

The Decision by the United States Circuit Court of Appeals for the Fourth Circuit in Petroleum Exploration v. *Commissioner is Erroneous.*

The decision of the United States Circuit Court of Appeals for the Fourth Circuit in the case of *Commissioner* v. *Petroleum Exploration* (not yet reported, but a copy is printed as an appendix to the petition for certiorari herein) is based upon the following theory:

1. The taxpayer had the option of charging these drilling expenses as operating or current expense and deducting them all in the year they were expended or of charging them to capital investment and recovering them through depreciation, but when it exercised the option and charged them to invested capital it must have elected to recover only those portions which the regulations permitted, and this election is binding.

2. The cost of drilling the hole is not properly subject to depreciation because there is no wear and tear, and

3. The long and consistent administrative construction as evidenced by the Regulations is binding upon the taxpayer.

The Court for the Fourth Circuit contends that Article 223 of the Regulations gave the taxpayer the option to either charge the expenditures made in drilling the hole to current expense and deduct them all in the year which made or to charge them to capital account and secure a return of such portions as were permitted by the regulations for the deductions for depletion and depreciation, and that when the taxpayer elected to charge these to capital expenditures he assumed all the obligations and burdens of the regulations and must abide strictly by the same.

In the first place, the respondent contends that, as has been heretofore shown, a proper construction of the regulations requires the deduction for depreciation upon the cost of drilling the hole as well as all the other costs of the completed oil well.

In the second place, if it did not require such a construction, certainly the taxpayer was entitled to believe that under this regulation he would be permitted to recover all of his expenditures and therefore can not be charged with an election. Further than this, the taxpayer really did not have the right of election since, as has been shown in the case of *Old Farmers Oil Company* v. *Commissioner*, 12 B. T. A. 203, and *Consolidated Mutual Oil Company* v. *Commissioner*, 2 B. T. A. 1067, as well as the case of *Jergins Trust Co.* v. *Commissioner*, 22 B. T. A. 551, the Board of Tax Appeals has held that these expenses are not properly chargeable as current or operating expenses, and the Commissioner has no right to permit such a charge, but they are properly capital investments and should be so charged. In the next place, if the expenditures were made in the first year of the operation of a company in which there would no doubt not be sufficient income to permit the charging off of the entire investment, the taxpayer could only recover the same through a process of a charge to capital investment and deductions for depreciation, and under the regulations this election once made can not be changed. Therefore, the taxpayer did not in reality have any such an election and this hypothesis of the opinion by the Court for the Fourth Circuit is erroneous.

The Circuit Court of Appeals for the Fourth Circuit then holds that these costs should be recovered through depletion and not through a deduction for depreciation. It is respectfully submitted that what has been heretofore said in the discussion of the other portions of this brief clearly establishes that this theory is unsound. The court points out that if the contention of the respondent is sustained, then Article 223 is robbed of any meaning since there is no expense whatever connected with an oil well except as to the exploration of the property which would be included in the deduction for depletion.

It is respectfully submitted that the depletion deduction was intended to cover only the value of the mineral deposit, and that the contention of the respondent in this case leaves such intention entirely operative. The flat percentage was fixed in order to do away with the difficulties attendant upon the discovery value and that is in no manner interfered with by

the decision of the Court of Claims. Article 223 has the full meaning which Congress intended consistent with the proper construction of the statute and the intention of Congress.

The Circuit Court of Appeals for the Fourth Circuit then suggests that the regulations have the force and effect of law as well as the implied approval by Congress, and that the long and consistent administrative construction of the statute as given in these regulations should be upheld by the courts. The respondent recognizes the rule of law that a long and consistent administrative construction of a statute will be given respectful consideration by the court, but as has been heretofore shown it is respectfully submitted that the construction of the regulations now contended for are entirely at variance and inconsistent with the statute. The rule of law is equally familiar that in such circumstances the statute must prevail.

Further than this, there was no such long and consistent administrative construction as would require the court to uphold these regulations in this case, nor can it be said that such regulations were impliedly approved by Congress. As has been heretofore shown, we believe that a proper construction of the regulations sustains the contention of the respondent. As there is no ambiguity in the statute, therefore the regulations construing the same can not in any way vary the terms of the statute. The regulations under the Revenue Act of 1926 are not of long standing, nor are they uniform. Before the Revenue Act of 1926, depletion was based upon a discovery value as the rate of exhaustion. Therefore, prior to this act, so far as the costs of the kind here involved were concerned, it made no difference whether they were allowed as depreciation or depletion. The full amount of such costs could be ultimately recovered upon the basis of exhaustion, but the Revenue Act of 1926 made radical changes in the law with reference to the depletion of oil wells, and did not base such depletion upon a discovery value or the rate of exhaustion, but based the amount of allowable depletion each year upon a flat percentage of the income which had absolutely no relation to value or costs of the property or to the rate of exhaustion. To say that Congress and the Revenue Act of 1926 adopted the regulations

previously existing, requires a wild stretch of the imagination. At that time, the existing regulations dealt with a question of depletion involving the cost or value of the property and the rate of exhaustion. The new act changed all of this and placed depletion upon an entirely different basis. The assumption that Congress adopted such existing regulations is not justified. The courts will not give these regulations the same weight that they would have been given had the law not been so radically changed. The regulations must be tested upon their own merits, and when so tested they are found either to justify the deductions claimed by the respondent or else to be inconsistent with the new statute.

CONCLUSION.

For the reasons heretofore set forth, it is respectfully submitted that the petition for writ of certiorari should be denied.

Respectfully submitted,

HERMAN J. GALLOWAY,
Attorney for Respondent.

LOUIS P. DONOVAN,
Shelby, Montana,
Of Counsel.